CBOE
CHICAGO BOARD OPTIONS EXCHANGE

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September 30, 2004

Ms. Jean A. Webb
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: CME Submission #04-94

Dear Ms. Webb:

In the above-referenced submission, the CME certified amendments to its equity index options rules that convert all of its equity index options from American-style exercise to European-style exercise. CBOE submitted a comment letter to the CFTC[1] and attached a paper ("CBOE Analysis") that analyzed the CME's proposal. The CBOE Analysis concluded that, under the CME's proposal, equity index options that expire in a month in the March-June-September-December quarterly cycle ("quarterly options") will be cash-settled, will not qualify as options on futures and will be options on a group or index of securities that fall outside the coverage of the Commodity Exchange Act ("CEA").

The CME submitted supplemental information by letter to the CFTC dated September 20, 2004 ("CME Letter").[2] The CME Letter attempts to characterize the exercise of a European-style quarterly option as a two-step process in which the option is first exercised into a stock index futures position, and the stock index futures position is later settled in cash. However, as pointed out in the CBOE Analysis, the CME's argument exalts form over substance. For the following reasons, it is clear that, in economic reality, the European-style quarterly options are options directly on a group or index of securities:

First, under CME's rules, such an option cannot be exercised until after the last day of trading for the option, which is also the last day of trading for the futures contract. Thus, the party who exercises the option has no opportunity to trade or hold the underlying futures contract. There is no economic difference between an option that is cash-settled directly upon

[1] Letter from William J. Brodsky, Chairman and CEO, CBOE, to David Van Wagner, Division of Market Oversight, CFTC, dated September 15, 2004.

[2] Letter from John W. Labuszewski, Director, Research & Product Development, CME, to Jean A. Webb, Office of the Secretariat, CFTC, dated September 20, 2004.

exercise and one that is "posted" as a futures position in the CME's trade register after the termination of trading for the futures contract and then automatically converted into cash. Therefore, any assertion that the option exercises into a futures contract is simply misleading.

Second, the determination of whether the quarterly option is "in the money" shows that such option is based on the cash market stock index price and not the futures market price. Compare footnotes 12 and 13 in CME Rule 351A02.A. Under footnote 12, a quarterly option is deemed to be in the money if the "Final Settlement Price" lies above the exercise price in the case of a call, or lies below the exercise price in the case of a put. The "Final Settlement Price" for CME's S&P 500 futures contract is defined as a special quotation of the S&P 500 Stock Price Index based on the opening prices of the component stocks in the index on the third Friday of the contract month. In contrast, under footnote 13, the determination of whether a serial month option is in the money is made by comparing the exercise price of the option with the settlement price of the underlying futures contract determined in the futures market. This demonstrates that the true "underlying" for the quarterly options is not a futures contract, but rather the price of the stock index as determined in the cash market.

Third, when a European-style quarterly option is exercised, it is cash-settled based on the value of the stock index as determined in the cash market, rather than by prices determined in the futures market. In this way, the proposed CME European-style quarterly options are indistinguishable from the stock index options that are traded as securities options on CBOE and other national securities exchanges.

The CME letter points out that CFTC Rule 33.4(b)(2) allows a futures exchange to trade options on a cash-settled futures contract where the option expires simultaneously with the expiration of the futures contract. Of course, the Part 33 rules apply to options on futures and options on physical commodities generally, and the rules do not purport to address the special legal and jurisdictional issues raised by options on securities or a group or index of securities. The law is clear that the CFTC has no jurisdiction over options that are directly on securities or a group or index of securities. Section 2(a)(1)(C)(i) of the CEA provides that the CFTC shall have no jurisdiction over, and the CEA shall not apply to:

> "any transaction whereby any party to such transaction acquires any put, call, or other option on one or more securities . . . , including any group or index of securities, or any interest therein or based on the value thereof."

Citing this statutory language, the Court of Appeals for the Seventh Circuit stated that even where an instrument can be deemed to be both a futures contract and an option on a security, the SEC is the sole regulator of the instrument because the CFTC has no jurisdiction over options on securities. Chicago Mercantile Exchange v. SEC, 883 F.2d 537 (7th Cir. 1989).

The CME Letter also notes that CME rules adopted in 1995 permit European-style flex options on stock index futures. We are not aware that the jurisdictional issue raised in the CBOE

Analysis was identified or considered by either the CFTC or the SEC in the context of the CME's flex options. In any event, to the extent that the CME's flex options share the same characteristics as the European-style quarterly options described in the CBOE Analysis, then those flex options should also be prohibited unless and until the CME becomes registered under Section 6(b) of the Securities Exchange Act of 1934.

As we said in our original comment letter, if the CME does not voluntarily terminate its plan, or amend its rules so as to bring them into conformity with applicable law, we are asking the CFTC to take appropriate action to ensure that there is no trading in these contracts without full compliance with the law, thereby avoiding later rescission of these contracts as void under Section 29 of the Securities Exchange Act of 1934. In particular, we request that the CFTC stay the effectiveness of CME's rule amendments, pursuant to CFTC Rule 40.6(b), while the CFTC fully considers the propriety of CME's self-certification.

If you have any questions regarding this matter, please contact the undersigned.

Sincerely,

Joanne Moffic-Silver

cc: Ms. Annette Nazareth, Division of Market Regulation, SEC
Mr. David Van Wagner, Division of Market Oversight, CFTC
Mr. Craig S. Donohue, President and CEO, CME